

BEFORE THE
DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
WASHINGTON, D.C.

TRANSATLANTIC, TRANSPACIFIC, TRANS-
BORDER, AND LATIN AMERICAN SERVICE
MAIL RATES INVESTIGATION

Docket OST-96-1629

DISCUSSION OF INTERNATIONAL MAIL RATE METHODOLOGY

Attached to this cover sheet is an Executive Summary used in discussions between officials of the U.S. Postal Service and the Department of Defense and officials of the Department of Transportation on November 24, 2003, with respect to the cost impact on the Postal Service and Defense Department of international mail transportation rates based on the existing allocated cost methodology compared to rates based on incremental or marginal costs.

The same information had previously been conveyed to representatives of U.S. flag carriers providing international service in discussions on November 21, 2003.

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International Mail Rate Methodology Discussion

USPS Presentation to DOT

25 November 2003



Background – DOT Rates & Volumes by Region

- US international mail transportation rates are regulated by the DOT. The base rates were established in the late 1970s, primarily on a volume-based allocated cost methodology. Rates include a 12% return and are periodically updated by calculating an index based on the carriers' 18 month trailing costs (actual costs incurred for 12 month period with a proration for 6 months), assuming a linear relationship.
- The 2003 DOT established rates for linehaul (varies with distance) and terminal handling (non-distance variable) are summarized below.

DOT Region [Avg Daily Tons] ^{\1}	Mail Type	Linehaul Charge ^{\2} (\$ / Billing Ton-Mile)	Terminal Charge ^{\3} (\$ / lb)
Atlantic [133]	<i>Priority & MOM^{\4}</i>	\$0.3849	\$0.4231
	<i>Space Available</i>	\$0.2467	\$0.3815
Pacific [73]	<i>Priority & MOM</i>	\$0.5662	\$0.4400
	<i>Space Available</i>	\$0.3491	\$0.3809
Latin [19]	<i>Priority & MOM</i>	\$0.4479	\$0.3281
	<i>Space Available</i>	\$0.3449	\$0.3038
Transborder [56]	<i>Priority & MOM</i>	\$0.3320	\$0.4702

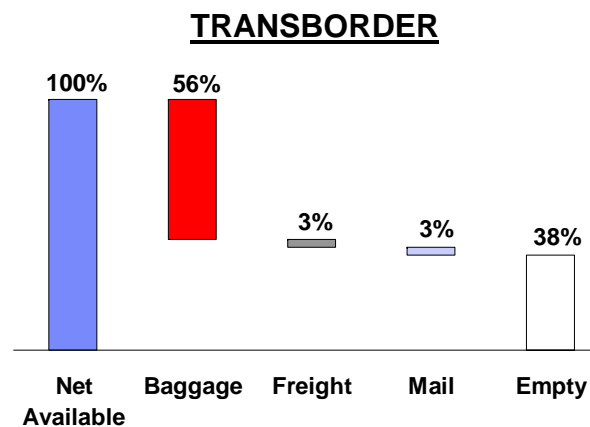
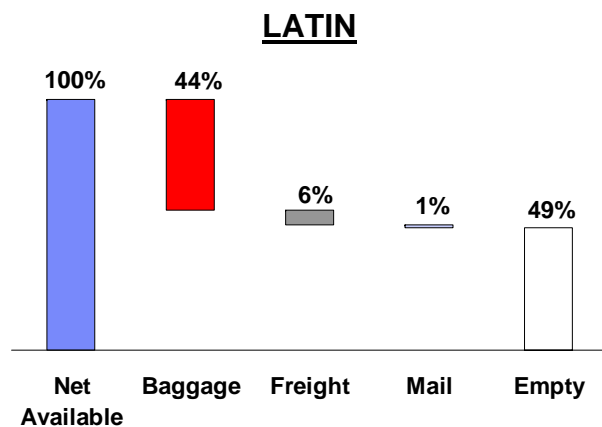
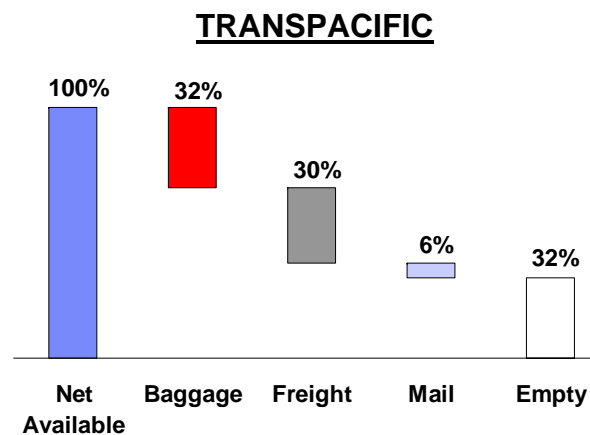
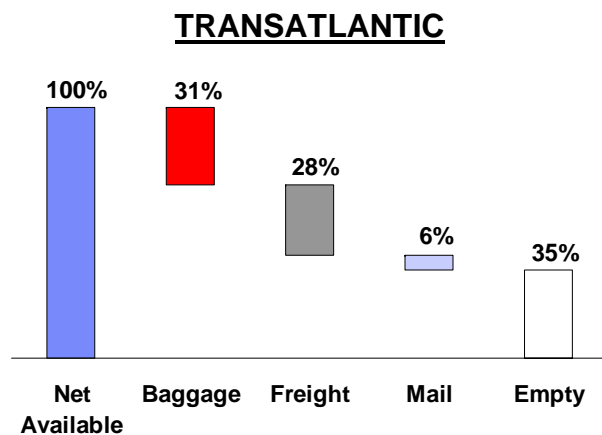
NOTES: \1 2002 Average daily tons - represents combined military and civilian volumes, based on 365 days of tender per year.
\2 Linehaul rates for sacks, rounded to four significant digits after the decimal.
\3 Terminal charges for sacks for all regions. For transborder, terminal charges include taxi, departure and terminal rates.
\4 MOM – Military Ordinary Mail.



Background – Load Factor Analysis

US OUTBOUND BELLY LOAD FACTOR BY PRODUCT BY REGION: 2002 ^{\1}

(Weighted Average Percent for DOT Carrier Pool)



SOURCES: Analysis based on data from US DOT T-100, USPS, Boeing, Airbus.

NOTE: ^{\1} For Transpacific, FX and NW freighter main deck statistics were included in the load factor calculation, per DOT carrier pool



Approach

- Given a probable rate increase for CY 2004, USPS sought to understand the appropriateness of the CAB / DOT base rate methodology vis-à-vis provider cost relationships.
- To assess the reasonableness of the existing transportation rate, DOT's allocated cost method was compared with one based on marginal cost.
- The marginal cost method (*Incremental Cost*) is rooted in an activity-based cost model
 - Utilizes appropriate fixed and variable cost components
 - Applies to both combination and all cargo carriers
 - Is appropriate since the transportation of mail is incremental to the primary business of carriers
 - Combination carriers: The transportation of passengers and their baggage
 - All cargo carriers: The transportation of organic products and palletized / containerized freight
- Based on the findings, not only is a potential increase in rate not justified, rather – a departure from current methodology towards a marginal cost approach appears to be warranted.



Illustration of Allocated Vs. Marginal Cost Methodologies

How much should Orville pay his brother Wilbur to watch a pay-per-view boxing match on Wilbur's plasma TV, while he is on vacation?

ALLOCATED COST METHODOLOGY

DAILY MORTGAGE, HVAC,
DEPRECIATION, SET-UP, CLEANING,
OVERHEAD (O/H)

\$ 110

+

TELEVISION DAILY LEASE
& ELECTRICITY, O/H

\$ 8

+

CABLE DAILY CONNECTION
CHARGE, O/H

\$ 5

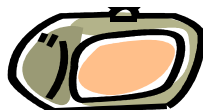
+

BOXING MATCH
VIEWING CHARGE, O/H

\$ 30

=

\$ 171



> 5X

MARGINAL COST METHODOLOGY

DAILY MORTGAGE, HVAC,
DEPRECIATION, SET-UP, CLEANING,
OVERHEAD (O/H)

\$ 0

+

TELEVISION DAILY LEASE
& ELECTRICITY, O/H

\$ 0

+

CABLE DAILY CONNECTION
CHARGE, O/H

\$ 0

+

BOXING MATCH
VIEWING CHARGE, O/H

\$ 30

=

\$ 34



NOTE: This analogy is given for purposes of anecdotal & notional illustration of marginal vs. allocated cost. The example is not intended to accurately reflect the differences in the costing methodologies for international mail transportation.

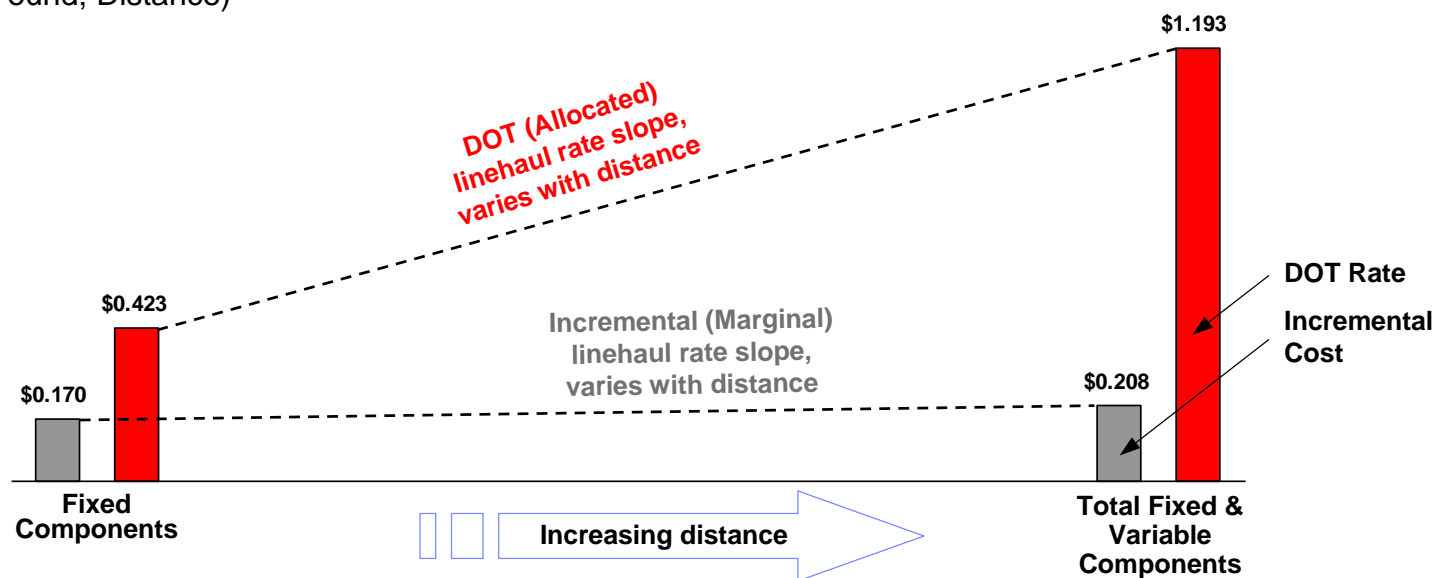


Allocated Versus Marginal Cost Methodologies

- The DOT (or allocated) method starts off with a higher fixed cost than does the incremental (or marginal) cost method because the allocated method includes airport facility charges in its entirety, which are not included in the marginal cost approach.
- The allocated method grows with distance at a much faster rate than does the marginal cost method, since the marginal cost approach excludes aircraft lease, maintenance, pilots, terminal facilities and much of the fuel expenses – consistent with marginal costing principles.

COMPARISON OF METHODOLOGIES – ALLOCATED VS. MARGINAL

(USD / Pound; Distance)

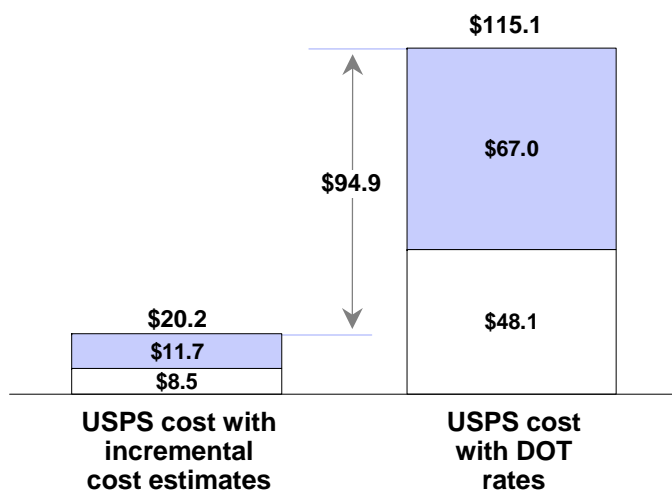




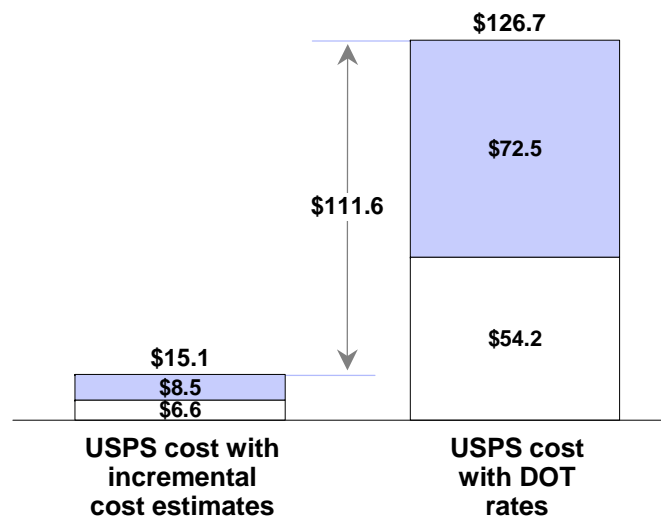
USPS International Mail Transportation Cost by Region

USPS ANNUAL COST BY METHOD: CY2003^{\1}
(USD in Millions)

TRANSATLANTIC



TRANSPACIFIC



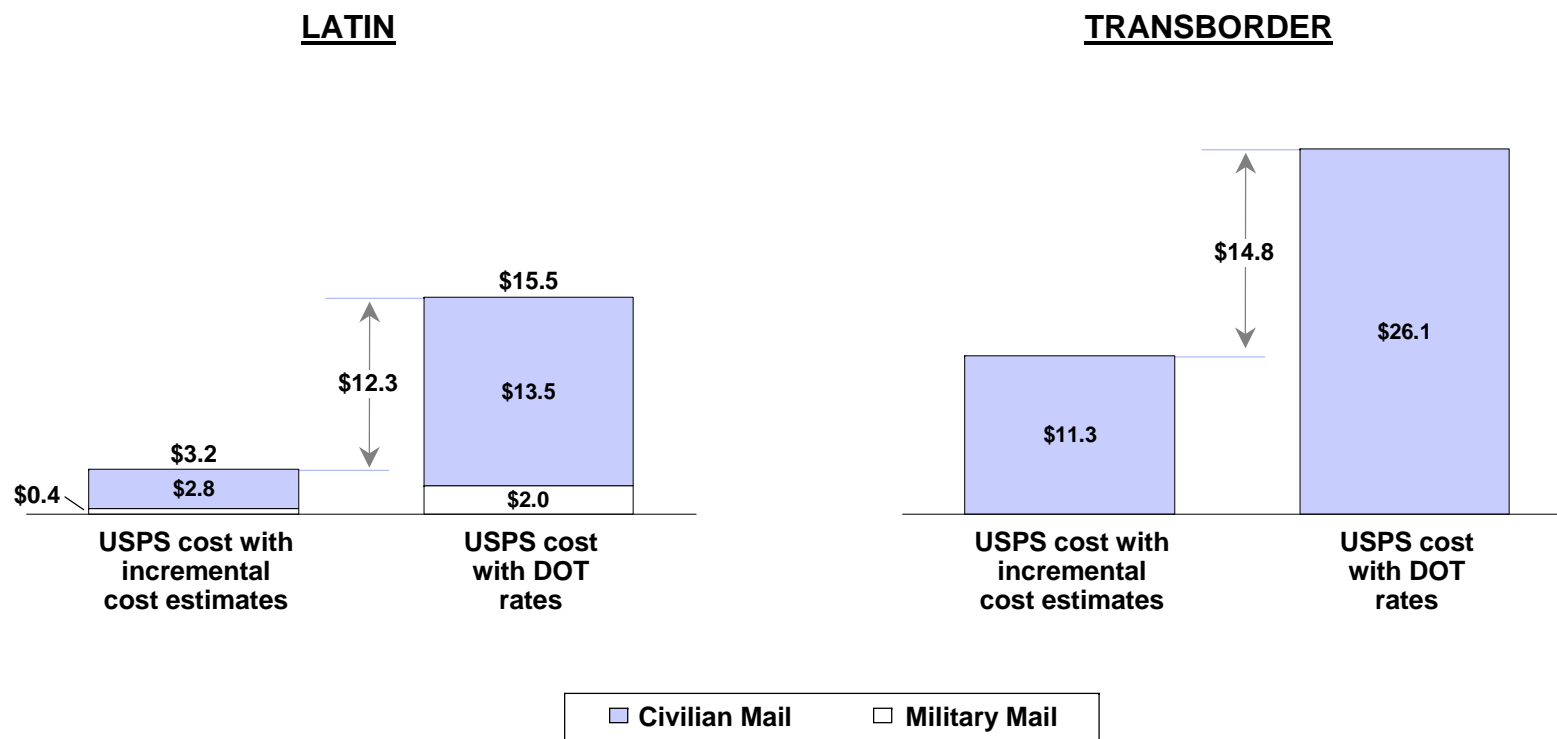
■ Civilian Mail □ Military Mail

NOTE: \1 Total cost based on average length of haul assumption of 4,000 miles for Transatlantic and 7,000 miles for Transpacific routes; assuming that regional volumes and distribution patterns for 2003 are the same as in 2002. Military mail figures include MOM and SAM (Space Available Mail) volumes at appropriate DOT rates.



USPS International Mail Transportation Cost by Region

USPS ANNUAL COST BY METHOD: CY2003^{\1}
(USD in Millions)



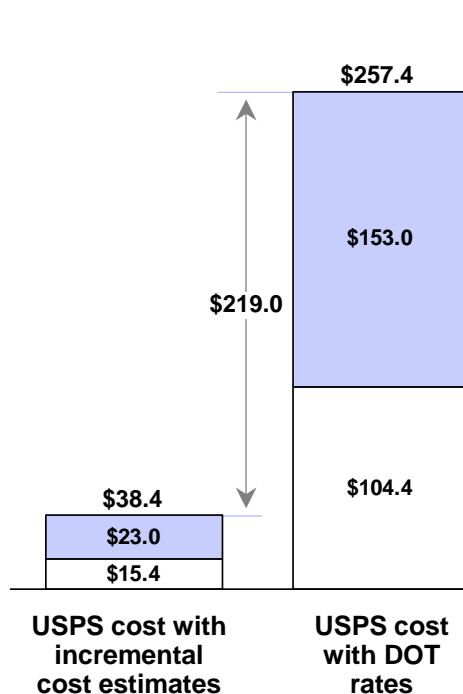
NOTE: \1 Total cost based on average length of haul assumption of 3,500 miles for Latin and 1,000 miles for Transborder routes; assuming that regional volumes and distribution patterns for 2003 are the same as in 2002. Military mail figures include MOM and SAM volumes at appropriate DOT rates.



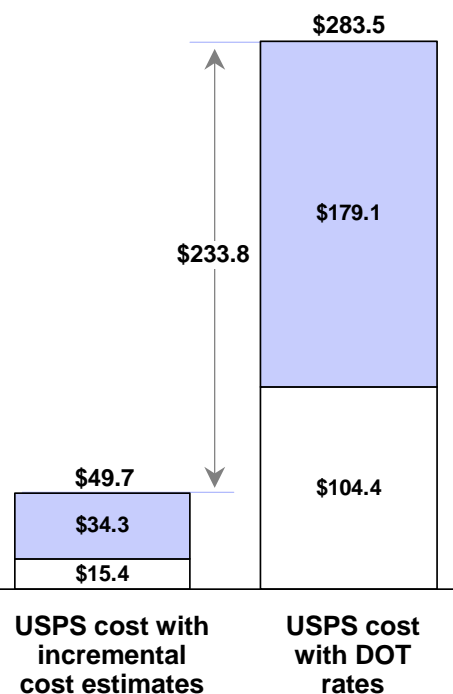
USPS International Mail Transportation Cost – Summary

USPS ANNUAL COST BY METHOD: CY2003^{\1}
(USD in Millions)

TOTAL WITHOUT TRANSBORDER



TOTAL ALL REGIONS



■ Civilian Mail □ Military Mail

NOTE: \1 Total cost based on average length of haul assumption by region; assuming that regional volumes and distribution patterns for 2003 are the same as in 2002. Military mail figures include MOM and SAM volumes at appropriate DOT rates.

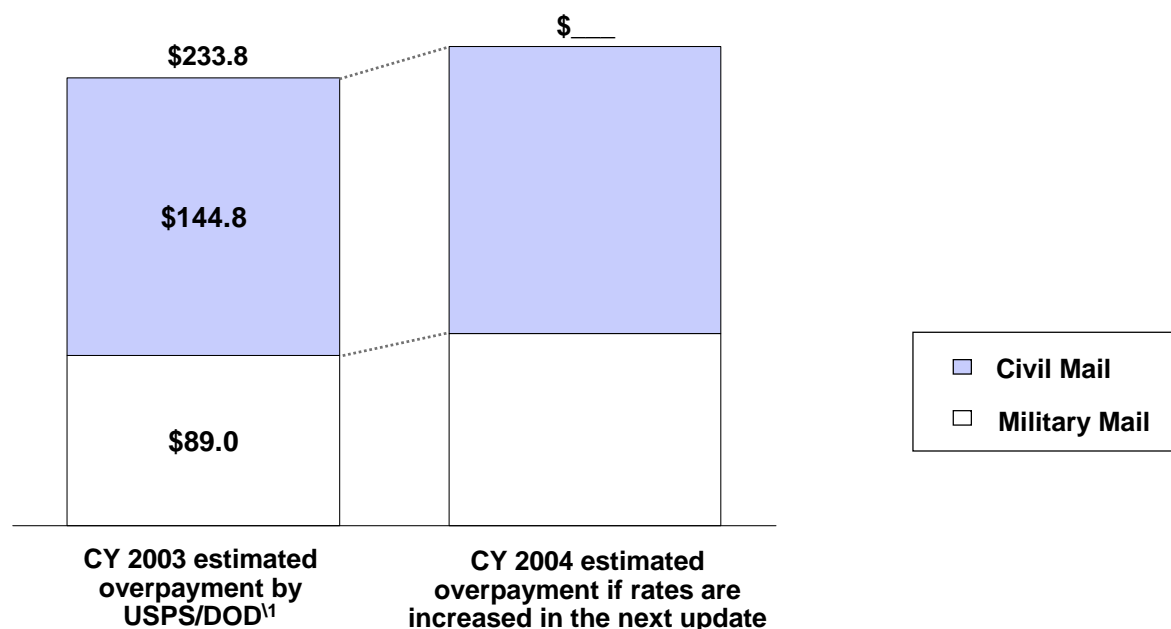


Conclusions

- The rate resulting from periodic indexing of the 1970's CAB / DOT allocated cost method appears to be more than 5X greater than the rate produced by a marginal / incremental cost based method for international mail transportation.
- The next update (January 2004) could potentially increase the rates and thereby expand the gap to more than the current estimated \$233 million overpayment.

ESTIMATED ANNUAL OVERPAYMENT

(USD in Millions)



NOTE: ¹ Total cost based on average length of haul assumption by region; assuming that regional volumes and distribution patterns for 2003 are the same as in 2002. Military mail figures include MOM and SAM volumes at appropriate DOT rates.



Conclusions & Recommendations

- To the degree that USPS costs must be reflected in its prices, USPS retail consumers and the military appear to be subsidizing the transportation of non-USPS products.
- Indeed, the CAB agreed in principle with the application of marginal costing principles for transportation of mail (“... it is our intention that the costs assigned to mail reflect a marginal approach to the extent justified by the record in this proceeding.”)^{\1}
- Any potential increase in rates is counterintuitive, rather – a departure from current methodology towards a marginal cost approach appears to be warranted.
- Accordingly, to ensure that mail pays only the rates commensurate with its cost-causative nature, USPS will formally request DOT to change the methodology by which international mail transportation rates are established.
 - Alternative methods available to the DOT include:
 - A process by which DOT conducts a competition for transportation of USPS international mail product among qualified carriers
 - A process by which DOT supervises a competition conducted by the USPS (similar to the recent contracts for parcels on select lanes) for transportation of international mail product among qualified carriers
 - The establishment of rates based on the marginal cost methodology
 - DOT support of future USPS deregulation efforts would be mutually beneficial.

NOTE: \1 Order 79-7-17 issued on 3 July, 1979, page number 27.



USPS Strategic Alternatives

- USPS has several strategic alternatives available to it within current regulations.
- USPS has requested outside advisors to quantify the cost, service and procurement issues associated with each alternative.
- USPS shared these strategic alternatives and study results with the Air Transport Association (ATA).

Alternatives

Solicit contracts for international air transportation of all non-letter class products (similar to the parcel contracts negotiated recently that resulted in substantial savings as compared with DOT rates)

Assign 100% of non-letter class international mail to a single combination carrier for each geographical region

Assign 100% of non-letter class international mail to a single integrated carrier for all geographical regions



Supporting CAB/DOT Docket Excerpts

- “Among other things, a factual-based marginal cost analysis permits a much more accurate picture of what joint product rates ought to be, and eliminates much of the rough judgment that goes into capacity causation.” (page 23 Order 78-11-80 issued 16 November 1978)
- “We are more than a little troubled by the possibility that the rates we have set here are too high from the standpoint of efficient pricing, given the extent of the excess capacity in the aircraft bellies apparent on this record.” (page 23 Order 78-11-80 issued 16 November 1978)
- “If the transportation of mail is truly a minor by-product of passenger transportation (a reasonable presumption given the predominance of passenger traffic and revenues and the large amount of unused capacity in the bellies of combination aircraft), capacity costs allocable to mail under a truly marginal cost analysis could approach zero. This is true because any reasonably foreseeable increase or decrease in the volume of mail would not have any serious cost consequences from a capacity standpoint.” (page 27 Order 79-7-17 issued 3 July 1979)

NOTES: Page numbers refer to specific numbers in the CAB / DOT order.